Part I

Section 801.—Tax Imposed

Rev. Rul. 2014-15

ISSUE

Does the arrangement described below constitute insurance within the meaning of subchapter L of the Internal Revenue Code? If so, does the issuer qualify as an insurance company?

FACTS

X, a domestic corporation whose stock is widely held, provides health benefits within certain limits to a large group of named retired employees and their dependents, even though it is not legally obligated to do so, and may cancel the coverage at any time. X maintains a single-employer voluntary employees' beneficiary association that satisfies the requirements of § 501(c)(9) (VEBA) and makes a contribution to the VEBA to provide the health benefits. X deducts the contribution in accordance with, and to the extent permitted by, §§ 419 and 419A of the Code. X has complied with, and will continue to comply with, all requirements of the Employment Retirement Income Security Act of 1974, as amended (ERISA).

In connection with the provision of health benefits to retirees and their dependents and as an alternative to providing the benefits on a self-insured basis, the VEBA enters into Contract A with an unrelated commercial insurance company, IC. IC's participation in the arrangement is a condition of an exemption from the Department of Labor from certain of the prohibited transaction provisions of ERISA.

IC is taxable as a life insurance company under § 801 of the Code. Contract A provides noncancellable accident and health coverage. Under Contract A, IC will issue quarterly reimbursements to the VEBA for medical claims that are incurred by the covered retirees and their dependents and paid by the VEBA. Contract A is regulated by the relevant State insurance commissioner as an accident and health insurance contract. At the time that Contract A goes into effect, neither X nor the VEBA have any commitment or obligation to offer health benefits to the covered retirees and their dependents, and both X and the VEBA may cancel any provided coverage at any time.

In an effort to keep the premium payment under Contract A affordable, IC then enters into Contract B with X's wholly owned subsidiary, S1, under which S1 receives a premium and reinsures 100 percent of IC's liabilities under Contract A. Contract B constitutes S1's sole business. S1 is regulated as an insurance company under state law, and Contract B is regulated as insurance. The amount of premium under Contract B is determined at arm's length in accordance with applicable insurance industry standards. S1 possesses adequate capital to fulfill its obligations to IC under Contract B. There are no guarantees that the VEBA or X will reimburse S1 with respect to its obligations under Contract B, nor is any of the premium received by S1 for Contract B loaned back to the VEBA or X. In all respects, the parties conduct themselves consistent with the standards applicable to an insurance arrangement between unrelated parties, except that S1 does not reinsure any other insurance contracts.

LAW

Subchapter L of the Code sets forth the regime for taxing insurance companies. In particular, § 801(a) provides that a life insurance company must pay tax on its life insurance company taxable income, which is defined in § 801(b) to mean life insurance gross income less life insurance deductions. Section 816(a), in part, defines a life insurance company as an insurance company that has life insurance reserves and unearned premiums and unpaid losses on noncancellable life, accident, or health policies comprising more than 50 percent of total reserves. Under § 816(a), the term “insurance company” means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 831(c) applies the same definition of "insurance company" to determine whether a taxpayer is an insurance company other than a life insurance company and therefore subject to tax under § 831(a).

Neither the Code nor the regulations define the terms “insurance” or “insurance contract.” The United States Supreme Court, however, has explained that for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), cert. denied, 340 U.S. 853 (1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Id. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. Id. By assuming numerous, relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. Id.

Courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1153 (Fed. Cir. 1993) ("Risk distribution involves spreading the risk of loss among policyholders."); see also Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986) ("[R]isk distributing' means that the party assuming the risk distributes his potential liability, in part, among others."); Crawford Fitting Co. v. United States, 606 F.Supp. 136, 147 (N.D. Ohio 1985) ("[T]he court finds . . . that various nonaffiliated persons or entities facing risks similar but independent of those faced by plaintiff were named insureds under the policy, enabling the distribution of risk thereunder."); AMERCO and Subsidiaries v. Commissioner, 96 T.C. 18, 41 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992) ("The concept of risk-distributing emphasizes the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risk between insureds."). Accordingly, Rev. Rul. 2005-40, 2005-2 C.B. 4, concludes that an arrangement under which an issuer contracts to indemnify the risks of a single policyholder does not qualify as insurance for federal income tax purposes because those risks are not, in turn, distributed among other insureds or policyholders. Similarly, Rev. Rul. 2002-89, 2002-C.B. 984, concludes that the requirements of risk shifting and risk distribution are not satisfied when a wholly owned subsidiary's agreement to indemnify the risks of its parent represents 90% of the subsidiary's business.

In Rev. Rul. 92-93, 1992-2 C.B. 45, modified by Rev. Rul. 2001-31, 2001-1 C.B. 1348, a parent corporation carried insurance on its employees' lives under a group-term life insurance contract purchased from its wholly owned insurance subsidiary. In concluding that the value of insurance was includible in the employees' gross income, the revenue ruling stated:

> Although [parent corporation] purchased the group-term life insurance contract covering its employees from its wholly owned insurance subsidiary, S1, this fact does not cause the arrangement to be “self-insurance” because the economic risk of loss being insured shifted to S1 is not a risk of [parent corporation]. . . . This insurance on the employees’ lives is an economic benefit to the employees since it relieves them of the expense of providing life insurance for themselves.

Revenue Ruling 92-93 states that “[t]he holdings of this revenue ruling also apply to accident and health insurance.” See also Rev. Rul. 92-94, 1992-2 C.B. 144.

ANALYSIS

To determine the nature of an arrangement for federal income tax purposes, it is necessary to consider all the facts and circumstances of a particular case, including the risks being shifted and distributed. The proper characterization of an arrangement may determine whether the issuer qualifies as an insurance company for federal income tax purposes and whether amounts paid under such arrangement may be deductible.

In the situation above, the risks being indemnified are the covered retirees’ and their dependents’ risks of incurring medical expenses during retirement due to accident and health contingencies. Although the VEBA entered into Contract A, the covered retirees’ health insurance is an economic benefit to the retirees since it relieves them of the expense of purchasing health insurance for themselves and their dependents. Furthermore, at the time that Contract A goes into effect, neither X nor the VEBA have any commitment or obligation to offer health benefits to the covered retirees and their dependants, and both X and the VEBA may cancel any provided coverage at any time. Consequently, the risks that are shifted in the situation above are those of the covered retirees and their dependents and not risks of the VEBA or X. These risks are reinsured by S1 under Contract B. The risks under Contract B are distributed among this large group of covered individuals, and the analyses of Rev. Rul. 2002-89 and Rev. Rul. 2005-40 are inapplicable. Accordingly, the risks under Contract B are insurance risks, and Contract B constitutes insurance for federal income tax purposes.

HOLDING

In the situation above, S1 is regulated as an insurance company under state law. Contract B constitutes insurance. Because Contract B is more than half of the business done by S1 during this year, S1 qualifies as an insurance company under Subchapter L for this taxable year.

This revenue ruling does not address whether the health benefits are provided through a self-insured medical reimbursement plan for purposes of the nondiscrimination rules under § 105(h) (see Treas. Reg. § 1.105-11(b)(1)(iii)).

This ruling also does not address the deductibility of a contribution by X to the VEBA under §§ 419 and 419A; whether S1, or any account held by IC or S1, with respect to Contract A or Contract B is a welfare benefit fund (as defined in § 419(e)); or the application of § 419A(g). Furthermore, because the arrangement described in this revenue ruling provides welfare benefits through a VEBA, this ruling does not address certain issues that would arise if an employer provided welfare benefits other than through a VEBA, including whether an entity (or any account held by any person) that is part of such an arrangement is a welfare benefit fund or, if not, whether the arrangement is a plan deferring the receipt of compensation for purposes of §§ 404(a)(5) and 404(b).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 2002-89 and Rev. Rul. 2005-40 are distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is Sheryl B. Flum of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Ms. Flum at (202) 317-6995 (not a toll-free call).